

Macro Outlook

Hard Road to Recovery...



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Summary:

- **In a regional comparison Ukraine is hardest hit by this recession, but it would be somewhat quicker to recover** comparing to other countries which also had experienced significant external disbalances in previous years (Bulgaria, Romania etc).
- Unfolding commodity exports will become a winning card for the economy in the medium term. **Metallurgy is to deliver a firm comeback, albeit it would take two to three years to reach production volume of 2007.** Inefficiency of Ukrainian soviet-era steel plants has been largely offset by continuous weakness of local currency coupled with decisive government support.
- **Household consumption still strong, but it will deteriorate over the course of the year** as incomes suffer from inflation and mounting weakness in non-manufacturing sectors. **Investment is to remain in doldrums scrunched by lack of credit, some de-freeze due to revival of infrastructure projects is expected in Q3.**
- **Currency market is to operate under dirty peg regime through the rest of 2009 and in 2010.** In the short-medium term National bank will continue to support local currency at “equilibrium rate” (levels needed to bring external trade roughly to zero). Currently UAH should be valued at around 7.7, with NBU probably defending domestic currency within +/-5% from that point for Q3.
- **Maintaining budget liquidity will be a challenge as budget will continue to experience drastic shortfalls.** Our estimates imply that government would still see nearly UAH 40 bn funding gap, which most likely would result into either a) monetary emission and/or b) necessity to restructure some of state commitments.
- **The key macroeconomic risk is excessive reliance on automatic stabilizers (such as large fiscal deficits)¹,** with little support programs being put into action. Indeed the size of stabilizers is huge so that can lead to significant distortions in distribution of domestic incomes, fragile hryvnya and higher inflation.

Our latest Macro Outlooks:

“ON THE ROCK BOTTOM” distributed on APR 29th

“LOOKING TO GET OUT” distributed on DEC 24th

¹In macroeconomics automatic stabilisers work as a tool to dampen fluctuations in real GDP without any explicit policy action by the government.

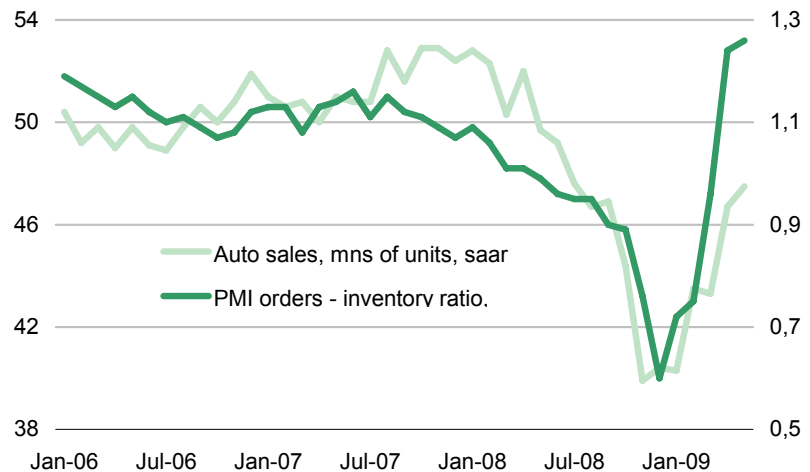
Baseline case				
	2008	2009E	2010F	2011F
<i>Business Cycle</i>				
Real GDP (%)	2.1%	-13.3%	1.9%	4.5%
Real Household Consumption	11.8%	-12.6%	3.4%	3.7%
Real Gross Fixed Capital Formation	1.6%	-42.5%	5.0%	6.0%
Real Government Consumption	0.4%	-4.4%	-3.1%	1.5%
Nominal GDP (UAH bn)	950.5	956.7	1098.7	1320.4
Nominal GDP (\$bn)	179.3	121.1	129.3	143.5
GDP per Capita (at F/X rate; \$)	3890.2	2627.0	2803.9	3113.3
Real Industrial Output (% y/y)	-2.3%	-21.2%	4.4%	10.9%
Real Agricultural Output (% y/y)	17.2%	0.5%	-1.5%	3.0%
<i>Prices</i>				
GDP Deflator	29.1%	16.5%	12.7%	15.0%
CPI	22.3%	19.5%	12.0%	11.8%
PPI	23.0%	13.5%	10.5%	17.4%
<i>Public Finance</i>				
Revenues	231.0	223.1	256.2	307.9
Expenditures	241.0	274.0	258.8	297.6
Budget balance (% of GDP)	-1.1%	-5.3%	-0.2%	0.8%
Budget deficit (UAH bn, "-" is deficit)	-10.0	-50.9	-2.6	10.3
Total Public Debt (USD bn)	24.6	40.7	45	47
Total Public Debt (% of GDP)	13.7%	33.6%	34.8%	32.7%
External Public Debt (USD bn) (ex. IMF Loan)	11.2	13.5	17	18.2
Gross External Debt (USD bn)	103	91.5	112	125
Gross External Debt (% of GDP)	57.4%	75.6%	86.6%	87.1%
<i>External Balances</i>				
Exports (USD bn)	67.7	34.8	40.5	49.5
Imports (USD bn)	84.6	37.7	42.6	55.0
Merchandise trade balance	-16.9	-2.9	-2.1	-5.5
Services Trade Balance (USD bn)	2.7	1.4	1.8	3.1
Current Account Balance (USD bn)	-12.9	-0.3	1.2	-2.2
Current Account Balance (% of GDP)	-7.2%	-0.2%	0.9%	-1.5%
Capital and Financial Accounts Balance (USD bn)	12.7	-7.5	-2.0	0.0
FDI Inflow (USD bn)	9.7	3.5	4.0	9.0
FDI Inflow per Capita (\$)	210.4	75.9	86.8	195.2
Gross F/X Reserves (USD bn)	31.5	25.5	25.8	23.6
<i>MM&FX</i>				
Narrow Money (Monetary Base, % y-o-y)	31.5%	14.0%	15.0%	17.0%
Money Supply (M3, % y-o-y)	29.9%	-5.0%	22.0%	25.0%
UAH:USD (rate; e-o-p)	7.8	8.2	7.9	7.5
UAH:USD (avg.)	5.3	7.9	8.0	7.6

Source: NBU, SSC, MinFin. Forecasts: UkrSibbank

The main driving factors behind global recovery have had front-loaded impact on growth.

The main driving factors behind global recovery have had front-loaded impact on growth. Financial confidence has stabilized quickly and is manifested in buoyant primary market placements so far this year. Inventory cycle has proved to be on the upside, with delta inventories buttressing growth instead of sending it into nowhere. IMF actions were decisive and were able to provide support to countries, running the highest risks of sovereign defaults.

Global PMI and Auto Sales Proxy



Source: Brokers' Notes

Global growth is very likely to stutter later this year. First, **deleveraging in the banking sector is still in the train.** Balance sheets still have a long way to go in order to unlock lending to extent that might facilitate a pick-up in global consumer demand. In the US (and likes) we might see a very different consumer behavior, shifting from credit-driven demand to a more savings-oriented model. The process would take years to adjust.

Second, spare **capacity would continue to weigh on investments.** There is massive hole in global CapU rates. Manufacturing capacity utilization in the US was nearly 79% at the peak of the business cycle in the late 2007. Since that time it had declined to 76% in mid-2008 and to 66% over the last couple of months.

Emerging markets as a whole has a potential to outperform their western counterparts over the coming years. Asia and LatAm would deliver the strongest growth while CEE would lag behind, overburdened with external debts. We anticipate economies in the region (ex Baltics) to contract on average by 6.1%, recovering by half of percentage point next year.

GDP Forecasts, CEE (% y/y)					
	2008	2009	2010	2011	2012
Russia	5.9	-8.2	1.7	5.3	5.4
Ukraine	2.1	-13.3	1.9	4.5	6.0
Poland	5.0	-0.7	1.4	3.9	5.0
Hungary	0.7	-7.5	-1.0	3.7	3.9
Czech Republic	3.0	-3.9	1.7	5.2	4.8
Bulgaria	6.1	-5.0	-1.9	0.1	2.0
Romania	7.4	-7.3	-0.5	1.7	5.5
Turkey	1.1	-5.0	2.0	3.5	4.5

Source: BNP Paribas, UkrSibbank

In a regional comparison Ukraine is hardest hit by this recession, but it would be somewhat quicker to recover comparing to other countries which also had experienced significant external disbalances in previous years (Bulgaria, Romania etc).

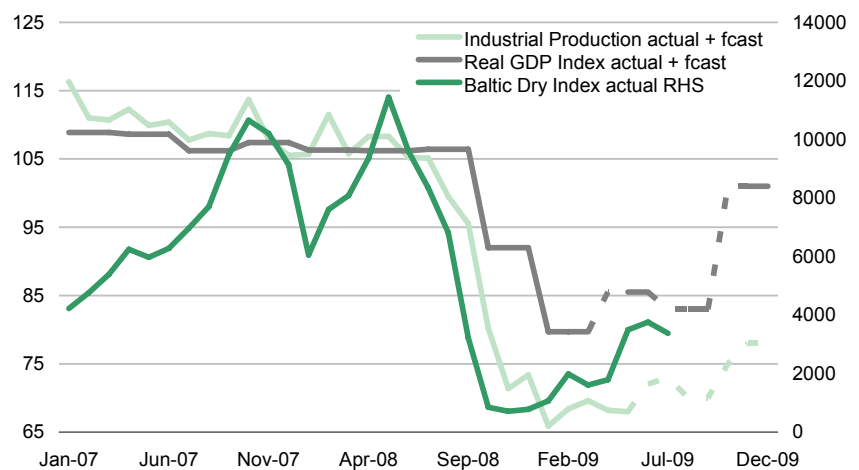
Unfolding commodity exports will become a winning card for Ukraine in the medium term

Unfolding commodity exports will become a winning card for Ukraine in the medium term, even if global growth disappoints for the most of 2H2009. Despite the fact that inflation fears have gone away for some period of time, outrageous public deficits across the globe would pull commodities back to agenda as inflation hedge. Given the remarkable ability of markets to telescope future into present, we expect Ukraine to outperform most of countries in CEE in 2010-2012 provided that world economy continues to recover over that period.

Ukrainian economy passed the trough in the first quarter of 2009, recording -20.3% y/y GDP growth.

Ukrainian economy passed the trough in the first quarter of 2009, recording -20.3% y/y GDP decline. We slightly changed our GDP forecasts, expecting somewhat sharper -13.3% full-year contraction in 2009 (versus -11.5% in previous version), followed by more vivid growth in 2010 (1.9% vs 1.2%).

Ukrainian GDP Growth, Industrial production and Baltic Dry



Source: NBU, SSC, Bloomberg

So far consumption is resilient to decline in economic activity...

Our key argument in the past was that Ukrainian household consumption would be (at least temporarily) resilient to decline of economic activity due to very large part of social transfers and benefits in the structure of incomes (over 40%). Indeed, in Q1 household consumption surprised on upside, declining by just 11.6% in real terms which may be attributed to loose fiscal policy which has helped households to maintain living standards.

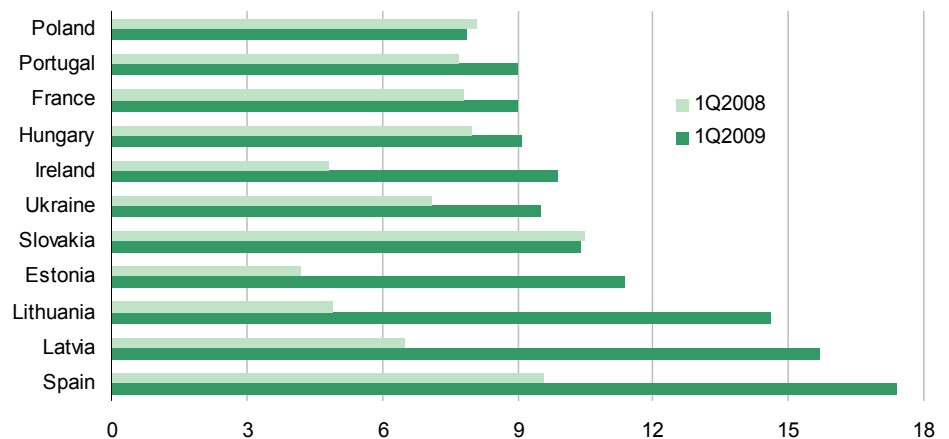
... but it will be depressed over four to six quarters to come.

We expect household consumption to deteriorate over the course of the year as incomes suffer from inflation and mounting weakness in non-manufacturing sectors. Consumption will be depressed for four to six quarters as balances of government, banks and corporate sectors will have to be repaired prior to increase in wages and social benefits.

Unemployment in the first quarter (ILO methodology) rose to 9.5%, compared to 7.1% one year earlier. There were 2 mn unemployed in Ukraine compared to 22 mn economically active population aged from 15 to 70. Under ILO standards historical trough on the labor market was in 1998, when number of unemployed soared to 3 mn (or 11.5%).

In our baseline scenario, we expect unemployment to climb as high as 12%, or two and a half percentage point from Q1'09. Still, unemployment in Ukraine to remain lower than in most countries in the EU (see Graph).

Unemployment, %, ILO standards



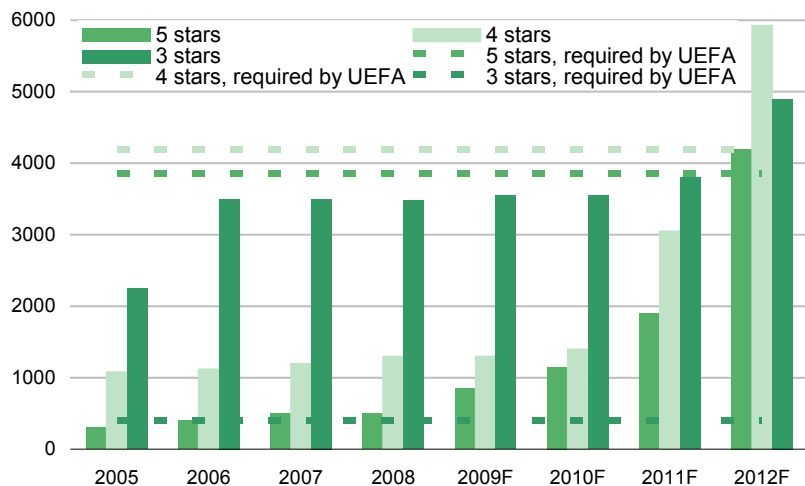
Source: State Statistics Committee of Ukraine, ILO

Investment is to remain in doldrums scrunched by lack of credit, some de-freeze due to revival of infrastructure projects is expected in Q3.

Investment is to remain in doldrums scrunched by lack of credit, some de-freeze due to revival of infrastructure projects is expected in Q3. Investment component of GDP nearly halved in Q1, recording -48.7% decline. The main culprits for contraction were large excessive capacities in industry, lack of capital and credit to modernize existing facilities. Inventories declined by \$1.8 bn, reflecting pick-up in global demand.

The key driver for 2009 is EURO-2012 coupled with very poor completion level of Ukrainian infrastructure projects. Government has recently amended the budget with UAH 9.8 bn to be forwarded primarily to domestic infrastructure construction in Q3 and that should spur investment activity. Still, majority of projects remain frozen until new capital is available at non-punishing rates. One can't think of some significant upsurge here at least until 2010 presidential elections are passed.

UEFA required number of rooms in hotels, Kiev*



Source: Colliers International, Jan 2009

*The only city in Ukraine approved by UEFA so far

Industrial production is crawling the rock bottom, recording -31.8% decline in y/y terms. Industrial sub-branches are in red across the board, with various types of engineering/machinery experiencing the sharpest (45%-65%) decline – mainly due to orientation on domestic consumption. In general, **export oriented industries will outperform over the course of next two years**, notwithstanding unfriendly global environment.

GDP Breakdown by Expenditure and Cross-Sectoral

	GROWTH															
	1Q2006	2Q2006	3Q2006	4Q2006	2006	1Q2007	2Q2007	3Q2007	4Q2007	2007	1Q2008	2Q2008	3Q2008	4Q2008	2008	1Q2009
Agriculture	103.8	104.9	95.3	111.5	102.0	104.8	107.1	90.5	94.7	95.0	100.5	99.5	121.9	120.7	117.2	101.3
Extracting industry	107.7	110.7	111.9	108.8	109.9	106.2	103.8	102.3	104.2	104.1	104.4	106.0	103.9	82.3	98.5	83.8
Processing industry	102.3	110.3	111.8	111.5	109.2	115.7	112.9	112.9	110.8	112.8	109.0	109.4	101.8	77.4	97.7	63.5
Gas. electricity. water	101.1	96.6	105.7	98.0	100.1	94.0	106.3	103.7	103.8	101.3	103.3	95.5	100.9	83.0	95.2	80.7
Construction	95.7	100.3	101.4	101.7	100.3	114.3	110.4	112.6	115.4	113.2	98.5	93.7	83.0	67.3	82.5	45.9
Trade and services	106.2	116.5	120.2	123.6	117.7	115.8	119.8	125.3	119.7	120.6	115.7	110.9	102.2	86.1	101.8	82.0
Transport&Communications	105.5	108.0	110.3	106.5	107.6	107.5	108.6	111.4	115.1	111.0	110.2	114.1	110.8	95.7	107.1	85.6
Education	101.0	103.2	99.1	104.1	102.1	101.0	105.1	105.6	105.0	104.3	100.8	99.6	96.6	100.4	99.4	97.2
Medicare	104.9	103.8	101.8	100.4	102.4	101.8	102.9	101.9	92.9	99.6	94.9	101.7	100.6	99.7	99.4	95.4
Financial Services	X	X	X	X	X	111.8	110.5	113.8	117.4	113.7	99.3	87.5	77.0	71.0	81.3	97.5
Real Estate	X	X	X	X	X	100.3	102.0	109.4	110.9	106.4	101.1	105.6	119.4	120.3	113.2	85.8
Government	X	X	X	X	X	97.5	99.4	99.8	89.0	96.1	103.4	100.3	108.2	100.6	103.1	87.3
Intermediaries (-)	X	X	X	X	X	X	X	X	X	X	108.5	101.4	96.0	89.3	97.4	127.5
Taxes	113.5	102.6	115.5	124.7	114.1	119.0	106.4	90.4	98.7	102.4	107.5	111.6	116.9	97.5	108.0	63.6
Output	111.3	101.8	108.8	106	106.8	108.9	108.6	106.2	107.4	107.6	106.3	106.2	106.4	92	102.1	79.7

	GROWTH															
	1Q2006	2Q2006	3Q2006	4Q2006	2006	1Q2007	2Q2007	3Q2007	4Q2007	2007	1Q2008	2Q2008	3Q2008	4Q2008	2008	1Q2009
Consumption	116.5	116.6	110.4	108.3	112.4	114.3	113.5	111.3	114.5	113.4	117.0	110.1	110.9	101.4	109.0	91.4
households	118.6	119.7	112.8	113.8	115.9	119.1	117.0	113.6	119.0	117.1	122.5	113.3	114.1	101.6	111.8	88.4
ngo	93.4	89.4	90.6	93.3	91.7	93.2	92.7	93.0	87.2	91.5	87.8	87.1	98.5	110.4	95.5	93.9
Government	111.2	108.6	102.5	94.3	102.7	100.2	104.2	104.0	102.4	102.8	99.8	101.3	100.1	100.2	100.4	101.8
individual	108.4	107.1	103.5	95.2	102.5	102.0	104.9	103.8	100.6	102.7	101.3	102.1	96.8	99.2	99.8	104.2
common	115.9	111.3	100.9	92.9	103.0	97.4	103.0	104.4	105.1	102.9	97.0	99.7	105.1	101.8	101.3	97.4
Investment	145.8	106.4	110.7	123.0	118.5	116.6	127.8	119.1	125.1	122.1	113.7	128.7	112.9	75.2	105.1	X
Gross Capital Formation	122.8	121.0	120.6	121.1	121.2	125.9	125.8	124.5	123.8	124.8	119.4	112.0	103.8	82.6	101.6	51.3
Change in inventories	X	X	73.1	99.9	X	X	113.1	81.5	103.3	X	X	X	X	X	X	X
Acquiring	120.5	70.6	91.8	135.8	107.4	153.1	188.9	126.9	121.7	138.9	87.2	107.7	109.4	107.7	102.5	81.2
Net Exports (Goods and Services)											100.0	100.0	100.0	100.0	100.0	X
Export of G&S	84.5	89.0	102.2	101.4	94.4	102.8	104.6	100.1	105.6	103.2	104.4	107.2	119.2	89.6	105.2	84.1
Import of G&S	111.3	101.8	108.8	106.0	106.8	114.7	120.7	115.5	127.2	119.9	123.8	124.4	129.6	95.8	117.1	64.4
Output	111.3	101.8	108.8	106	106.8	108.9	108.6	106.2	107.4	107.6	106.3	106.2	106.4	92	102.1	79.7

Metallurgy is to deliver a miraculous comeback, albeit it would take two to three years to reach production volume of 2007.

Metallurgy is to deliver a firm comeback, albeit it would take two to three years to reach production volume of 2007. Inefficiency of Ukrainian soviet-era steel plants has been largely offset by continuous weakness of local currency coupled with decisive government support. Variety of tariffs was regulated to the favor of key industries (including transportation and energy tariffs). Local chemical and metallurgical enterprises (including those in the steel, coke and mining sectors, but excluding tubes&pipes) were released from paying the 2% markup on natural gas. There is no doubt that the state would further support backbone of domestic economy.

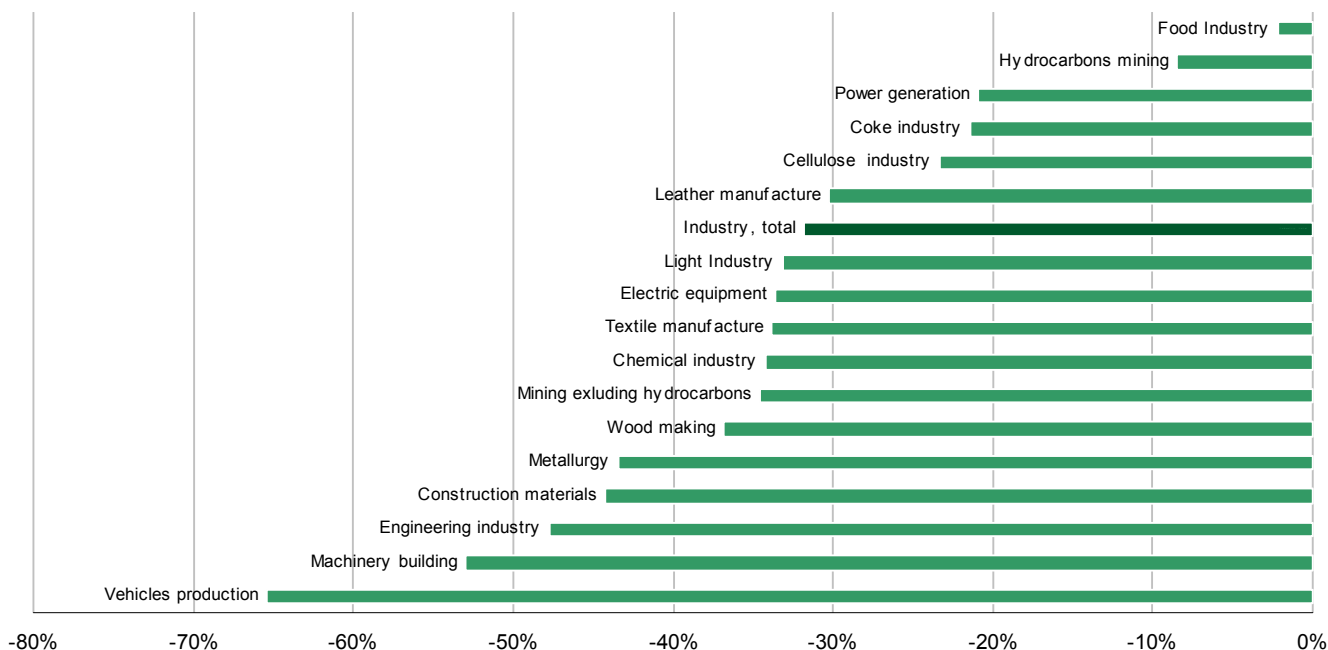
Ukraine’s chemical industry remains one of the most vulnerable to slowdown, in particular due to low fertilizers’ prices, inefficiencies and rising energy costs. The average global price of ammonia, ammonium nitrate and urea in 5M09 dropped by 40%..55%, while price of imported gas surged by more than 50%. Production of chemicals could rebound in Q4 when the price of imported gas would reach its lowest level (\$155 per tcm).

Food sector demonstrated remarkable resiliency. While drop in CIS foodstuffs consumption stipulated a significant downward revision of exports, food makers followed path of import substitution wherever possible. While over 5M it has recorded -2.1% decline, it will be the only industry to leave the red area in 2009. With major growth impulses stemming from agriculture, food processing is potentially one of the most attractive investment targets in medium-long term.

Competitiveness matters in mechanical engineering, where collapsing production of vehicles and electronic goods for domestic markets is becoming increasingly offset by export-oriented machine building, including power stations turbines, hydraulic pumps etc. mechanical engineering is to contract by roughly one third in 2009, overcoming -35% 5M decline.

Situation in power generation sector is reasonably grim. Decrease in output is lower than average across industries, helped by increasingly large share of “shadow economy”. But the balances of enterprises in this sector increasingly feel the effects of state regulation. Generation companies have to keep flat tariffs, purchase unneeded coal from state mines etc.

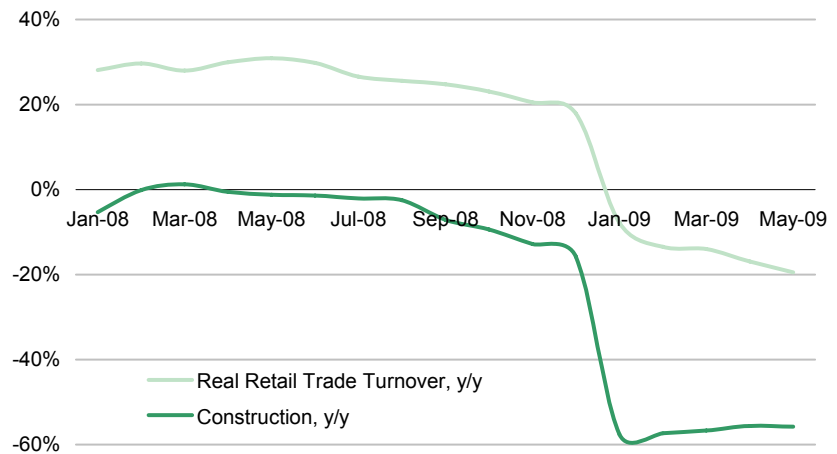
Industrial output dynamics across sectors, % y/y, 5M2009



Source: UkrSibbank

With -54.1% y/y construction is the worst-performing sector as it suffers from de-leveraging and depleting internal demand. The decline in construction reached its bottom in Q2 and for Q3..Q4 one could expect a slight rebound facilitated by low comparison base. Coming recovery would be driven by infrastructural projects first, and then by residential projects which are to receive aid in order to finish projects with highest stage of completion. Saturation in residential property market in Ukraine is one of the lowest across Europe, suggesting fall of demand was caused only by price bubble and lack of liquidity. Recovery in construction sector will prove to be extremely sluggish due to falling rental rates and punishing interest rates.

Retail Trade& Construction



Source: State Statistics Committee of Ukraine

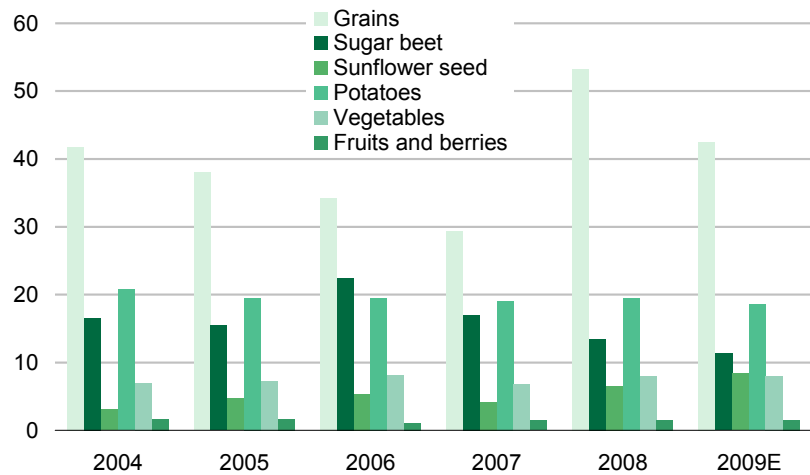
Trade and services are to experience further sharp decline, poisoned by ongoing retrenchment in consumer demand.

Trade and services are to experience further sharp decline, poisoned by ongoing retrenchment in consumer demand. We anticipate a slump from current -18% to -25% in Q3, before gradual recovery in Q4 starts. Presidential elections scheduled for Jan 09 to become the key driver resuscitating domestic sales via elections expenses (such as paid staff work), especially as presidential campaign is promising to become increasingly fierce). Gradually unfolding consumer lending would also support retail trade. Volumes in wholesale trade will be pushed up by recovering exports (a large part in wholesale trade is metals).

Transportation and communications are performing above expectations (-14.4% in Q1), notwithstanding almost a twofold decrease in external trade. Demand in transportation has been partially offset via flow of passengers which dries up significantly slower than that of cargo. Communications proved to be counter-cyclical with most of operators comfortably surviving the decline (albeit with some cuts in CapEx).

Agriculture inched up, being the single sector to record positive growth in Q1. Over 2008 marketing year (July 08 – July 09) Ukraine exported 24.7 mn tones of grain out of 53.3 mn harvest. This year’s weather conditions are less favorable. Ukrainian agricultural ministry forecasts total grain harvest to constitute 42.5 mn tones, with 17 mn tones export expectations.

Crop production, mn tones



Source: State Statistics Committee of Ukraine

We expect consumer prices to grow by 19.5% this year should the government implement adjustments in utility tariffs as demanded by IMF.

Ukrainian CPI inflation remains reasonably high at 15.0% y/y as of 1H2009. **We expect consumer prices to grow by 19.5% this year should the government implement adjustments in utility tariffs as demanded by IMF.**

Demand-side pressures subsided for six quarters at least. With local economy continuing shrinking in 2009 and barely expanding in 2010 we cannot sketch a scenario in which domestic demand would weigh on prices.

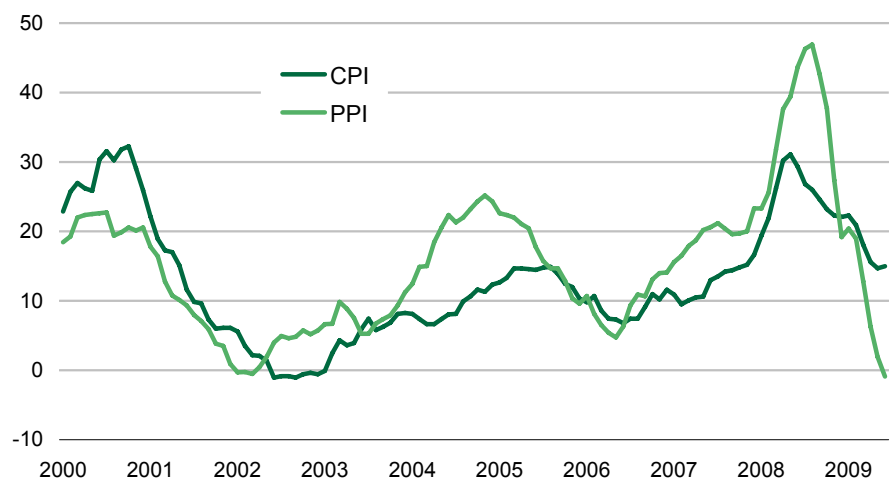
Poor fiscal performance is the key to renewed CPI growth. Many tariffs, duties etc were unchanged for years and faced ineludible correction as government struggles to fill purses, including those of quasi-sovereigns (e.g. in June - increase in tariffs by state railroads and rising telecommunications fees by state telecom). Prices of goods, controlled by the state, quasies or municipals will continue to rise, inducing supply-driven price growth over Q3 and Q4.

	Share	Jun09/Jun08
CPI	100.0%	15.0%
Food and non-alcohol beverages	53.1%	8.8%
Alcohol, tobacco	4.6%	40.0%
Clothes and shoes	7.2%	8.2%
Housing utilitiess	12.6%	34.7%
Household appliances	3.2%	23.6%
Medicare	2.8%	31.2%
Transport	3.9%	18.8%
Connection	3.2%	9.7%
Leisure&Culture	2.7%	20.2%
Education	1.7%	25.6%
Restaurants and hotels	2.7%	15.3%
Other goods and services	2.2%	30.0%

Source: State Statistics Committee

PPI numbers are mixed. Despite 1.4% m/m PPI increase in June, **the industry is largely in a deflationary cycle, recording -0.9% y/y.** Prices in export-oriented sectors are off-the cliff, while manufacturers oriented at domestic markets continued to increase prices. Oil was the single most important factor of PPI surge in June as refineries reported +16.1% price growth.

CPI&PPI monthly dynamics



Source: UkrSibbank

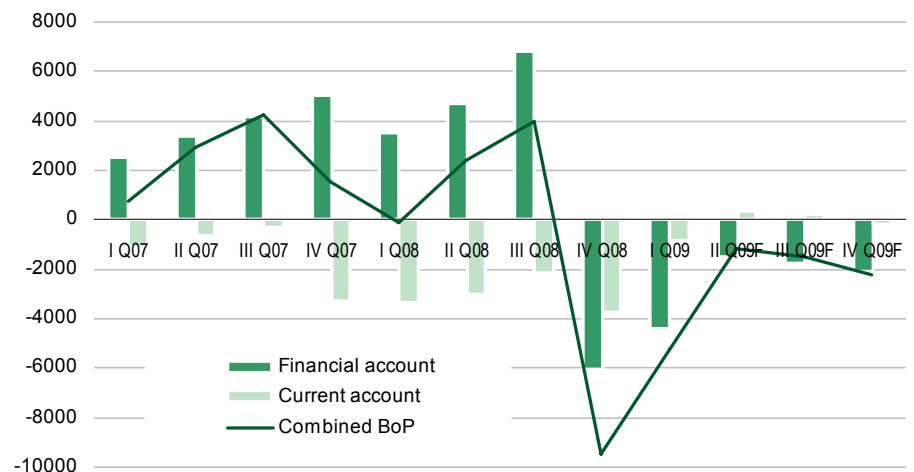
Current account is not problem for the exchange rate...

5M current account deficit decreased tenfold comparing to 2008 – from \$6.5 bn to \$0.66 bn At present, current account is not a problem for UAH exchange rate.

Merchandise trade balance is improving, shrinking to just \$1.7 bn (1.4% GDP). Exports have contracted by 53.2% y/y in May while imports fell by 58.9%. Such a drastic decline can be attributed both to lower physical volumes and collapsing prices. Steel and energy dominate export and import of Ukraine, respectively. With prices of steel falling about 2.5 times from their peaks in 2008 and prices of oil being still 2 times less than during the last summer, both sides are deflated significantly.

Volume of services declined by nearly one third and Ukraine continues to record a modest surplus in services – about \$412 mn as of 5M2009. Incomes and transfers push current account further towards balance as Ukraine receives CO2 funds from Japan (sale of greenhouse gas emission quotas under Kyoto protocol).

Balance of payments, \$ mn



Source: UkrSibbank

... but financial flows still weigh on BoP

Financial account reached -\$5.9 bn over 5M2009 and we expect it to continue deterioration to -\$8.5 bn as of full-year. Net FDI volume during 5M2009 reached \$1.8 bn, contracting 2.4 times comparing to 5M2008, banking sector prevails in the structure of FDI.

Net capital outflow (in loans and bonds) during this time landed at just \$2.7 bn, in particular due to high rollover ratios recorded in the banking (74%) and real (103%) sectors. High rollover in the banking sector is something that one could well expect, given intensive presence of foreign groups and high activity of domestic banks in restructuring their external debts. Very high rollover in real sector was something that was not widely expected as Ukrainian non-financial businesses are primarily owned by domestic groups. An answer to this phenomenon could be that lion's share of capital inflow registered as "foreign" is indeed of Ukrainian origin. Perhaps it is the expatriated profit which returned to enterprises via offshore lending in order to maintain their liquidity and prevent wider bankruptcies.

The key risk to BoP is cash purchases by population. As was discussed above, impact of capital outflow was very modest. On the flip side, cash purchases by population constituted almost \$4.2 bn – 3.5% of this year's projected GDP in just five months! Should cash purchases intensify (as a result of increased risk-aversion), Ukraine might see very difficult time in terms of BoP.

Ukrainian hryvnya now stands at 7.7, roughly 66% lower than one year ago. Local currency seems to be cheap comparing to other currencies in the region, but Ukraine's vulnerability coupled with unstable political situation and fragile financial system weigh on the exchange rate.

National bank will continue to support local currency at "equilibrium rate"...

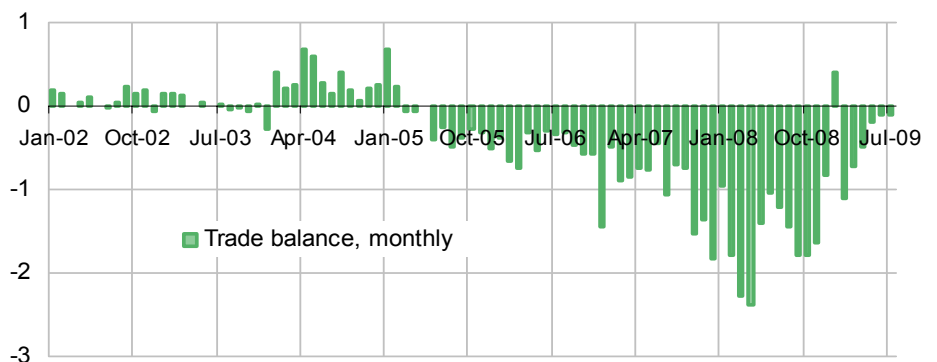
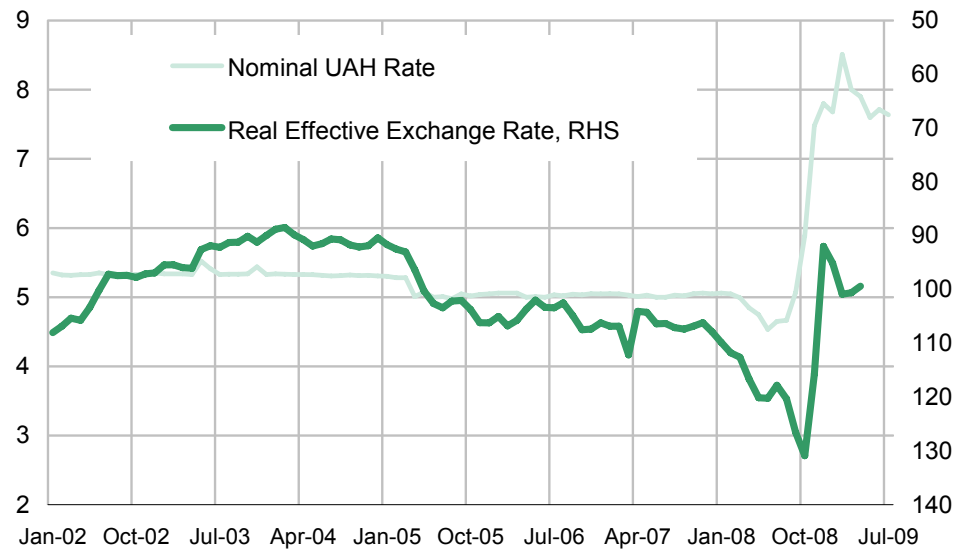
Ukrainian currency market is to operate under dirty peg regime through the rest of 2009 and in 2010. In the short-medium term National bank will continue to support local currency at "equilibrium rate" (levels needed to bring external trade roughly to zero). Currently UAH should be valued at around 7.7, with NBU probably defending domestic currency within +/-5% for Q3.

Depth of local market (\$200-\$400 mn daily volume) does not allow free float as large buying/selling orders significantly impact the market. Furthermore, given that regulator prohibited forward market operations in April, potential FX market volatility increased. Before moving to free float, central bank would face a difficult task of liberalizing the FX market that is not on agenda at the moment.

Currently UAH should be valued at around 7.7, with NBU probably defending domestic currency within +/-5% for Q3-Q4.

Currently "neutral" level stands at 7.7 vs USD, at this level REER roughly corresponds to 95-100 points and trade balance is approaching zero. In 3Q2007-3Q2008 REER was increasing due to extremely high inflation, while 4Q2008 devaluation brought correction to 2004-2005 levels.

UAH REER and Nominal Rate



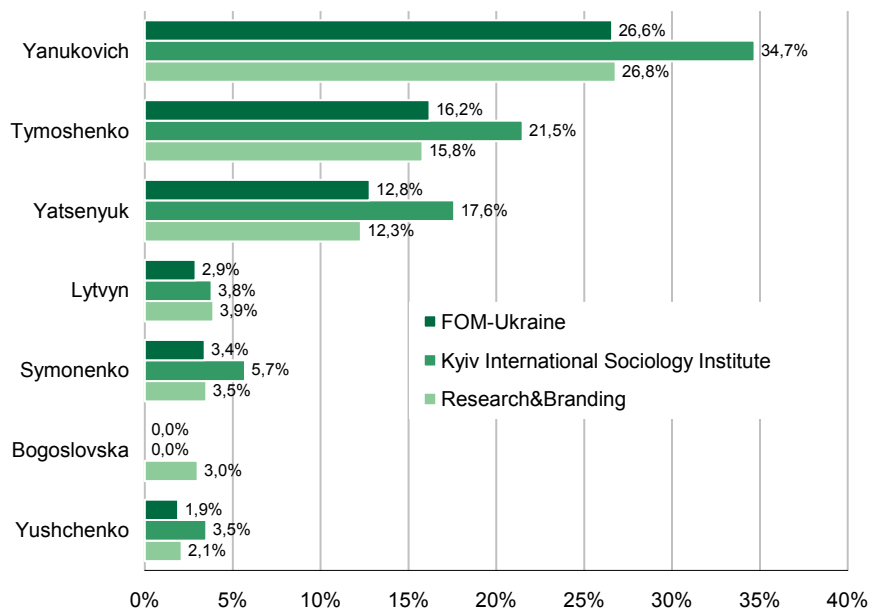
Source: IMF, UkrSibbank

The next milestone in political life is presidential elections scheduled to take place on Jan 17th 2010. Polls conducted by key domestic sociological firms suggest that three candidates have material chances to become the new president:

- *Viktor Yanukovych* (Party of Regions; backed by industrial sector, primarily exporters);
- *Yulia Tymoshenko* (BYT, backed by variety of businesses primarily oriented at domestic demand);
- *Arseniy Yatsenyuk* (Front of Changes, backed by large variety of businesses).

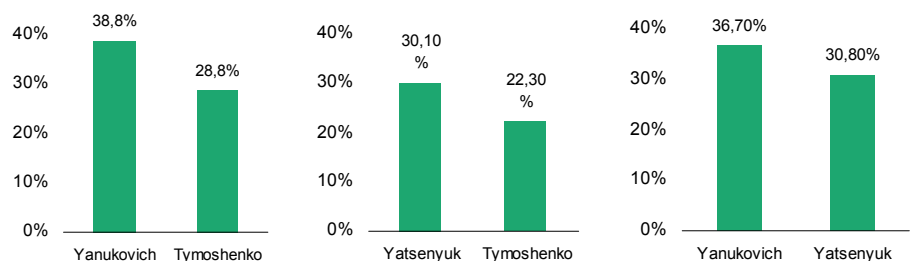
According to various polls, **Viktor Yanukovych currently has the highest chances to become the new Ukrainian president.** Presidential elections take place in two rounds. In the first round, two most successful leaders are determined. In the second round, the choice is limited to those two candidates. We considered three possible pairs of politicians, where Mr. Yanukovych wins in two of three cases with exception of pair Tymoshenko-Yatsenyuk. Latter final pair is unlikely though as Yanukovych has the highest support in the first round. However, given the remarkable ability of Mrs Tymoshenko to quick and efficient tactical moves, she still has fairly high chances for president's office.

Presidential polls – 1st round



Source: FOM, KISI, R&B

Presidential polls – 2nd round



Source: R&B

Maintaining budget liquidity will be a challenge as budget will continue to experience drastic shortfalls.

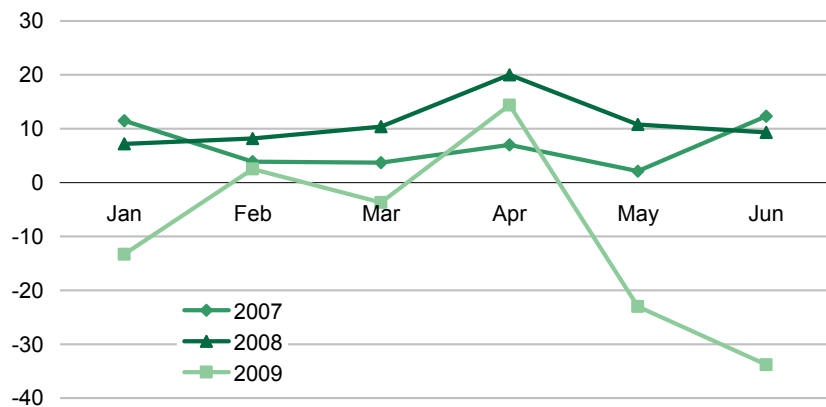
Revenues should reach 90% of the target in the best case

Maintaining budget liquidity will be a challenge as budget will continue to experience drastic shortfalls. The latest version of central government budget stipulates incomes of UAH 245.5 bn – UAH 184.0 bn to be received by the general fund and UAH 61.5 bn – to special fund. Incomes of regional budgets amount to UAH 134 bn while special government funds are to receive UAH 150 bn (net of transfers). **Altogether state plans to receive more than UAH 530 bn in incomes and revenues based on nominal GDP forecast of UAH 1047 bn.**

Expenditures of central government budget were set at UAH 274.0 bn implying UAH 28.5 bn deficit. Planned deficits of other budgets are included in central budget deficit since costs to cover their deficits are included to central budget.

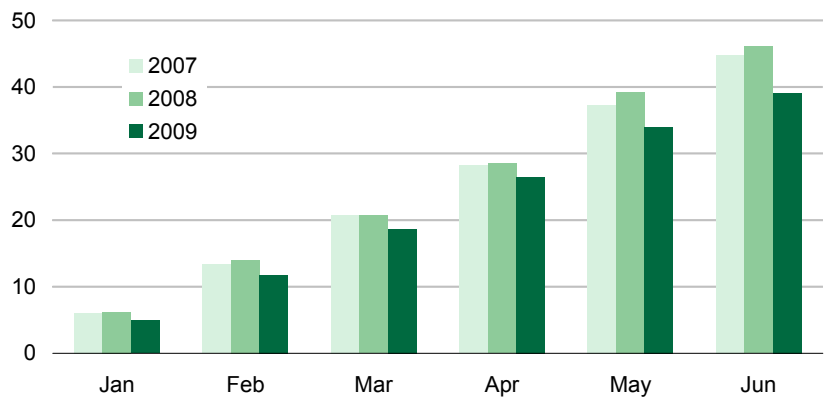
State treasury reported 1H budget performance at 104.1% of respective target. **In nominal terms revenues constitute only UAH 90.4 bn, which is just under 40% of annual plan.** During 2007-2008 over the first half of the year government was typically collecting about 45% of annual plan. Given that collection rate would remain similar until year end, one could expect that true revenues would be somewhere close to 90% of originally planned amount. As market rumors significant delays in VAT reimbursement in 1H2009, it is unlikely that revenues would demonstrate a significant surge.

Deviation of budget revenues vs plan sketched in January, %



Source: www.president.gov.ua

Budget revenues as % of annual income



Source: www.president.gov.ua

Key trigger to watch is cash deficit

Key trigger to watch is cash deficit. Lower than planned revenues at all levels create unforeseen deficits which need to be covered via additional borrowings and/or utilization of IMF funding².

Furthermore, in budget-2009 government has to redeem UAH 27.5 bn and spend about UAH 44.9 bn on increasing capitals of domestic banks. This stands against ambitious plans of borrowings and aggressive privatization program which is unlikely to be completed in 2009.

Our estimates imply that government would still see nearly UAH 40 bn funding gap

Our estimates imply that government would still see nearly UAH 40 bn funding gap, which most likely would result into either a) monetary emission and/or b) necessity to restructure some of state commitments.

On Jul 10th Ukraine reached staff-level agreement with IMF mission regarding the second program review. **Ukraine has successfully passed all quantitative efficiency criteria, maintaining 5M budget deficit below 2.5% GDP and net international reserves at \$19.7 (compared to floor of \$18.7bn).** Should Ukrainian authorities fulfill all qualitative criteria, the budget may receive additional \$1.9 bn (UAH 14.7 bn) in order to facilitate payments on sovereign and quasi-sovereign debts. However this action still needs approval of IMF's executive board.

Cash fiscal balance, UAH bn*	
Funding gaps	
Coverage of planned budget deficit	28.5
Additional deficit due to lower budget revenues	22.5
Redemptions	27.5
<i>Recapitalization</i>	44.9
Additional transfer to PF	8.0
Additional transfers to municipals**	5.0
Total funding gap:***	136.4
Sources of funding	
Leftovers on UAH treasury account from previous periods, 2009	6.1
Leftovers on FX treasury account from previous periods that can be used in 2009	5.4
<i>Internal bonds to be bought by NBU under recap</i>	44.9
Other internal bonds bought by NBU	11.3
IMF funds allocated to redeem external debt as a part of the second tranche	10.8
Privatization, EOY forecast	0.8
Internal borrowings (mid-term), EOY forecast	5.2
IFIs and sovereigns (loans from World bank, CO2 emission sales etc)	12.5
Total sources:	97.0
<hr/>	
Total open funding need	39.4

* Without the third disbursement under SBA

** Under assumption that municipals use opportunity to cover some of the shortfalls by cutting expenditures and attracting loans from domestic banks

*** Estimate as of Jul 1st 2009

Source: MinFin, NBU, UkrSibbank

² IMF Articles prohibit the fund from direct contribution to fiscal deficits. However indirect funding is possible on matters related to balance of payments. Another way is government securities' purchases by National bank of Ukraine and subsequent intervention on the FX market in order to wipe out additional liquidity.

The key macroeconomic risk is excessive reliance on automatic stabilizers

The key macroeconomic risk is excessive reliance on automatic stabilizers³, with little support programs being put into action. Indeed the size of stabilizers is huge so that can lead to significant distortions in distribution of domestic incomes, fragile hryvnya and higher inflation.

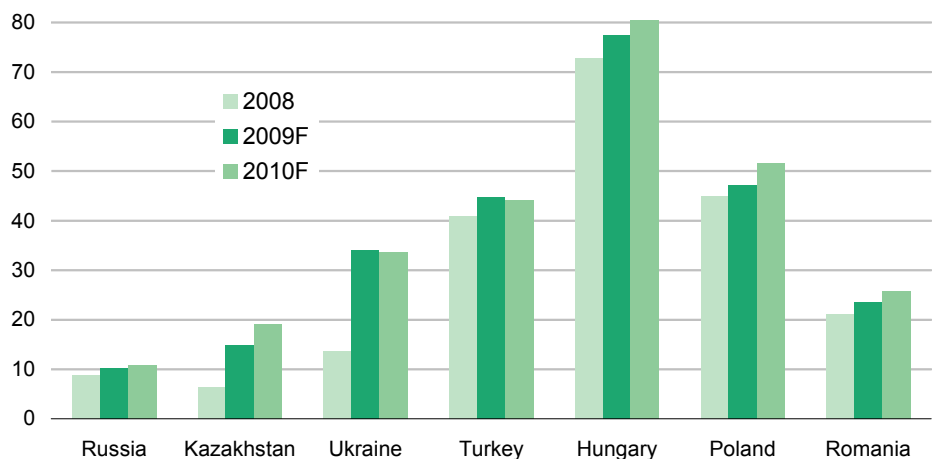
Unlike in many other countries, where fiscal policy became loose as a result of *additional* government support, Ukrainian public finances were overburdened with social spending *before* the economic slowdown began. The risk here is that final consumer (recipient of social spending) may prefer to save cash and convert it to hard currency, which would increase pressure on UAH. These funds do not necessarily reach banking system – in our Macro Outlook, dated Dec 24th, 2008, we showed that cash holdings by individuals outside of the banking system amount to 20-30% of GDP.

Economy needs more stimulus based on injection of long-term credit supply into banking system with subsequent increase in UAH denominated credit volumes and investment activity. It is not likely that such stimulus may appear in the short run due to the fact that state uses pretty much all opportunities to fund budget deficit. It is sort of crowding-out effect, not on capital markets but rather on using domestic money supply (capacities of National bank in increasing money supply are limited).

Ukrainian public deficits seem to be sustainable in the long run

Ukrainian public deficits seem to be sustainable in the long run, given that it had one of the lowest debt-to-GDP ratios in the region in the beginning of credit crunch. Even though state debt surges over 2008 and 2009, Ukraine still records moderate debt-to-GDP ratio comparing to its peers. We counted IMF loan towards debt of central government since looser fiscal policy (necessary to combat the crisis) is supported via central bank. At the end of the day, Ukraine would end up with debt-to-GDP ratio of about 34% at the end 2010 in our base case. In the **worst case scenario government debt to GDP grows to 42%, reaching 2008 level of Turkey (BB-) and still below Poland (A-).**

Public Debt/GDP*



Source: UkrSibbank

For Ukraine we have included IMF disbursements to public debt, albeit de-facto IMF tranches are accounted as state-guaranteed debt.

³ In macroeconomics automatic stabilisers work as a tool to dampen fluctuations in real GDP without any explicit policy action by the government.

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